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> In recent years, it has not been unusual for substantial construction undertakings to meet with financial disaster. Traditionally, . . . those parties most responsible for substantial losses cannot be made to respond to a judgment and, accordingly, aggrieved parties seek a "deep pocket." Attempting to solve complex issues of fact and law is somewhat like attempting to unscramble an egg. The court strives to do justice which oftentimes must be only approximate.
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> Chief Justice Littlejohn, Supreme Court of South Carolina in *Roundtree Villas Ass'n., Inc. v. 4701 Kings Corp.*, 321 S.E.2d 46, 48 (1984).

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INTRODUCTION

Persons supplying labor, equipment or materials to a lessee[1] for the construction or renovation of leased commercial property have been increasingly successful in imposing mechanics' liens[2] on the lessor's[3] property interest in order to recover monies due under a contract with the lessee.[4] These subcontractors and suppliers have used the lessor's continued involvement in the leased property through terms of the lease between the lessor and lessee in order to define the lessor as a financial "deep pocket" responsible as a principal for the actions of its agent lessee. Therefore, lessors must consciously elect to take a "hands-off" approach to their lessee's actions or engage in "hands-on" involvement in the operational oversight, financial, and other standard leasehold matters.

This Article examines the scope and development of the California "participating owner" doctrine, and explains the applicability of the doctrine to lien claimants[5] and commercial property owners. The remainder of this introductory section examines the reasoning behind the general rule that a lessor is not liable for mechanics' liens placed on its property by virtue of the acts of a lessee, and the many exceptions and prerequisites California and other state courts have imposed on the application of this rule. Section II provides a detailed overview of the

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1. A lessee is one who rents property from another. BLACK'S LAW DICTIONARY 902 (6th ed. 1990). In the case of real estate, the lessee is also known as the tenant. *Id.*

2. A mechanics' lien is a claim created by state constitution or statute for the purpose of securing priority of payment of the price or value of work performed and material furnished in erecting or repairing a building or other structure, and as such attaches to the land as well as the improvements erected thereon. *Id.* at 981.

3. A lessor is one who grants a lease or rents property to another. *Id.* at 902.

4. The contract between the lessee and the person supplying labor or materials can be either express or implied. The ability to imply a contractual relationship in the context of a mechanics' lien is usually based on statute. In California, for example, the Civil Code provides as follows: "The liens provided for in this chapter shall be direct liens, and shall be for the reasonable value of the labor, services, equipment, or materials furnished or for the price agreed upon by the claimant and the person with whom he or she *contracted*...." CAL. CIV. CODE § 3123 (West Supp. 1991) (emphasis added).

5. "Claimant" means any person who claims or asserts a right, demand or claim. BLACKS LAW DICTIONARY 247 (6th ed. 1990); *see infra* notes 57-62 and accompanying text (specifying the class of persons defined as "lien claimants" under California law).

constitutional and statutory sources of California Mechanics' lien law, as well as the balancing required for its judicial implementation.[6] Section III provides a factual review of the California cases on which the participating owner doctrine is based.[7] Section IV discusses lender liability for lessee mechanics' liens under the related lender liability doctrine.[8] Finally, in Section V, the options facing commercial property owners are analyzed in light of available California court decisions.[9]

I. BACKGROUND ON THE PARTICIPATING OWNER DOCTRINE

It was once a rather clear rule in a majority of states that the "voluntary" installation or provision of leasehold improvements[10] by a lessee or tenant did not subject the lessor's interest in leased property[11] to a mechanics' lien imposed by virtue of the lessee's contract with suppliers of labor or materials, even when the improvements permanently improve the leasehold property.[12] However, the breadth of this general rule has caused a majority of states to limit its application by providing a laundry list of

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6. *See infra* notes 52-104 and accompanying text (discussing the source and purpose of California mechanic's lien law).

7. *See infra* notes 105-53 and accompanying text (reviewing California cases discussing the participating owner doctrine).

8. *See infra* notes 154-62 and accompanying text (discussing lender liability).

9. *See infra* Section V (discussing the options facing a commercial property owner in the context of recent California authority).

10. The term "leasehold improvement" is used interchangeably with the term "work of improvement" which is defined by California statute. A "work of improvement" includes, but is not restricted to, the construction, alteration, addition to, or repair, in whole or in part, of any building wharf, bridge, flume, aqueduct, well, tunnel, fence, machinery, railroad or road, the seeding, sodding, or planting of any lot or tract . . . the filling, leveling, or grading of any lot or tract of land, the demolition of buildings or the removal of buildings. CAL. CIV. CODE § 3106 (West 1974). To qualify as a work of improvement and receive the protection afforded by the mechanics' lien statutes, the improvement must be permanent in nature. *See* Howard A. Deason & Co. v. Costa Tierra Ltd., 2 Cal. App. 3d 742, 753, 83 Cal. Rptr. 105, 110 (1969) (reversing a trial court decision allowing the foreclosure of mechanics' liens even though they were not timely filed).

11. *See* BLACK'S LAW DICTIONARY 813 (5th ed. 1979) (defining a lessor's interest in leased property is defined as the present value of the future income under the lease, plus the present value of the property after the lease expires).

12. 53 AM. JUR. 2D *Mechanics' Lien* § 131 (1964).

exceptions.[13] Under these exceptions, a mechanics' lien will attach to the lessor's interest in the leased property if either: (1) The lessor required, as a condition of granting the lease, the installation of substantial leasehold improvements,[14] or (2) the lessor has played an active and substantial role in the installation of the leasehold improvements.[15]

California has been a leader in holding lessors liable for the unpaid debts incurred by lessees for the construction of leasehold improvements. When the lessor requires the lessee to make leasehold improvements as a condition of granting the lease, the lessor's interest in the leased property is subject to a mechanics' lien imposed by virtue of the lessee's contract with contractors and suppliers.[16] This basis of liability was discussed in *Los Banos Gravel Co. v. Freeman.*[17] In *Los Banos*, the Freemans each owned a one-half interest in a parcel of land.[18] They entered into a lease with Circle Vending for a portion of their land.[19] The lease contained provisions under which: (1) The lessee was required to start construction within 120 days of executing the lease or the lease would become void; (2) the lessee could not make alterations to the property without the lessors' consent; and (3) the lessee was required to pay a portion of its gross profits to the lessor.[20] After construction began, the lessor posted and recorded a notice of nonresponsibility as provided for by California law.[21] The lessee failed to pay for the labor and materials used in construction, and the plaintiffs recorded mechanics' liens against the property.[22] The

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13. *Id.* at § 132.

14. Los Banos Gravel Co. v. Freeman, 58 Cal. App. 3d 785, 794-95, 130 Cal. Rptr. 180, 184-86 (1976). *See infra* notes 17-24 and accompanying text (discussing the Los Banos decision).

15. *See* American Islam Soc. v. Bob Ulrich Decorating, Inc., 132 N.E.2d 620, 622 (1956). *See infra* notes 25-32 and accompanying text (discussing the American Islam decision).

16. *Los Banos*, 58 Cal. App. 3d at 795, 130 Cal. Rptr. 180, 186.

17. 58 Cal. App. 3d 785, 130 Cal. Rptr. 180 (1976).

18. *Id.* at 787-88, 130 Cal. Rptr. at 181.

19. *Id.* at 788, 130 Cal. Rptr. at 181.

20. *Id.*

21. *Id. See* CAL. CIV. CODE § 3094 (West 1974) (discussing the requirements for a notice of nonresponsibility, where a notice of nonresponsibility is a document which provides notice to third parties that the owner has not caused improvements to be completed on the property).

22. *Los Banos*, 58 Cal. App. 3d at 790, 130 Cal. Rptr. at 182.

trial court entered judgment in favor of the owner and the plaintiffs appealed.[23] The California Court of Appeal reversed the trial court ruling on the ground that the making of improvements was not optional under the lease, and thus, the owner was liable for recorded mechanics' liens, notwithstanding the filing, by the owner, of a notice of nonresponsibility.[24] The decision reached in the *Los Banos* case has likely had an effect on the structuring of contract obligations and duties both in California and other states. For example, a lessor is not likely to take an equity position in the lessee's business in return for a reduced rental rate.

In the relatively mature Indiana decision in *American Islam Society v. Bob Ulrich Decorating, Inc.*,[25] the court addressed the scope of involvement which a lessor must have in leased property in order for its activities to be classified as active and substantial.[26] In *American Islam*, the American Islam Society was owner and lessor of commercial property.[27] The lease provided that the lessees were obligated to provide certain permanent improvements to the structure.[28] The lessees contracted with a contractor to have the leasehold improvements completed; however, upon the lessees' failure to pay for the improvements, the contractor recorded mechanics' liens against the property.[29] The trial court rendered a judgment against the lessor and ordered the foreclosure of the mechanic's liens.[30] On appeal, the Appellate Court of Indiana affirmed the trial court, and ruled that, under the circumstances, the lessor was responsible for the mechanics' liens.[31] In deciding the case, the court reiterated the rule which provides that "[w]here the vendor [lessor] has been active and instrumental in having the improvements made, the lien will attach

23. *Id.* at 787, 130 Cal. Rptr. at 181.
24. *Id.* at 794-95, 130 Cal. Rptr. at 184-86.
25. 132 N.E.2d 620 (Ind. App. Ct. 1956).
26. *Id.* at 622.
27. *Id.* at 621.
28. *Id.*
29. *Id.*
30. *Id.*
31. *Id.* at 623.

to the real estate where the vendee [lessee] failed to carry out his contract of purchase."[32]

In contrast to the Indiana decision, a Colorado court determined that a lessor's inducement to obtain a tenant by offering to contribute money toward the remodeling of the property does not equate to the lessor playing an active role in having the leasehold improvements installed.[33] In *Uni-Build Corp. v. Colorado Seminary*,[34] the defendant was the owner and lessor of commercial property.[35] At the time the lease was executed, the lessor posted a notice of nonresponsibility in accordance with Colorado law.[36] The lessee subsequently became insolvent and the contractor, with whom the lessee had contracted, recorded a mechanic's lien against the lessor's interest in the property.[37] The trial court denied recovery on the mechanic's lien and the contractor appealed.[38] The Colorado Court of Appeals affirmed, holding that the mere contribution of money toward the remodeling of leased property by the lessor was not "active participation" to an extent which would change the character of the relationship of the parties and make the lessor liable.[39]

As shown in *Uni-Build*, the decisions holding a lessor liable for mechanics' liens recorded due to the actions of the lessee, such as *Los Banos* and *American Islam*, are not, however, universally followed. Cases from Missouri courts[40] follow the *Los Banos* and

32. *Id.* at 622.
33. Uni-Build Corp. v. Colorado Seminary, 650 P.2d 1300, 1300 (Col. App. Ct. 1982).
34. 650 P.2d 1300 (Col. App. Ct. 1982).
35. *Id.* at 1301.
36. *Id.*
37. *Id.*
38. *Id.*
39. *Id.* at 1302.
40. *See* Mid-West Eng. & Constr. Co. v. Champagna, 397 S.W.2d 616 (Miss. Sup. Ct. 1965) (holding that where the lease obligated the lessee to make leasehold improvements, the fact that the lease could be terminated by the lessee and no time was fixed for construction of the improvements by the lease did not relieve the lessor of liability).

American Islam line of reasoning, while decisions from Michigan and Washington courts[41] do not.

The two legal bases which state legislatures and courts have invoked to support exceptions to the general rule of lessor nonliability are: (1) An implied agency relationship between the lessor and lessee; and (2) The implementation of a notice of nonresponsibility statute.[42] A lessee is not generally considered to be the agent of the lessor within the meaning of the mechanics' lien statute, merely as a result of a landlord-tenant relationship.[43] Nor is an agency created when the lessor gives the lessee permission to make leasehold improvements.[44] However, some courts, such as those in California, have recognized the existence of an implied agency relationship between the lessor and lessee to the extent of subjecting the lessor's interest in leased property to a mechanics' lien when, as discussed above, the contract *requires* or *obligates* the lessee to make substantial improvements to the property.[45]

The second method by which states have limited the general rule of lessor nonliability for mechanics' liens placed on property due to the actions of a lessee is through the implementation of a notice of nonresponsibility statute. Typically these statutes define the interests to which they apply and provide for specific time, place, and duration filing requirements.[46] If the property owner/lessor fails to comply with the nonresponsibility notice requirements, then it will be held liable for liens placed on the property by the party with whom the lessee contracted. The statute

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41. *See* J & I Serv. Station, Inc. v. Wash Wagon of Michigan, Inc., 327 N.W.2d 518 (Mich. App. Ct. 1982) (holding that a lessor was not liable for mechanics' liens imposed for failure to pay for lessee leasehold improvements where the lease did not require the lessee to make improvements); McCombs Constr., Inc. v. Barnes, 645 P.2d 1131 (1982) (holding that the property interest of the lessor may not be charged with liens for work performed at the lessee's request if the lease does not obligate the lessee to improve the leased premises).

42. 53 AM. JUR. 2D *Mechanics' Liens* at § 131.

43. *Id.*

44. *Id.*

45. *See supra* notes 19-24 and accompanying text (discussing liability stemming from contractual obligations to make improvements).

46. *See, e.g.*, CAL. CIV. CODE § 3094 (West 1974) or OR. REV. STAT. § 87 (1983).

in force in California is typical of nonresponsibility notice statutes in a majority of the states.[47]

Apparently unaware of the disregard California courts have shown for the majority rule of lessor nonliability for mechanics' liens placed on property due to the actions of a lessee, commercial property owners and developers have become increasingly involved in controlling the timing and scope of construction by their lessees, or in demanding equity participation in their tenants' businesses.[48] When a property owner/lessor is found to have overstepped his traditional lessor role by making such demands on lessees, courts have held the lessor liable as a "participating owner" for any mechanics' liens placed on the leased property.[49] The test used by California courts to determine when an owner/lessor will be classified as a "participating owner" is found in the case of *Baker v Hubbard*.[50] The *Baker* court held that a property owner/lessor will be found to be a participating owner when the terms of the lease impose a *mandatory* duty upon a lessee to make improvements to existing structures.[51] The method by which a party, such as the plaintiff in *Baker*, may recover from a lessor found to be a participating owner is by the filing of a mechanics lien on the property. Therefore, the next section of this Article provides some background on California mechanics lien law.

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47. For nonresponsibility statutes in other western states, see, e.g. COL. REV. STAT. § 38-22 (1973); MONT. CODE ANN. § 71 (1979); UTAH CODE ANN. § 38 (1953); ARIZ. REV. STAT. ANN. § 33-981 (1973). The California Legislature has passed a nonresponsibility statute which is discussed in two statutory provisions; *see* CAL. CIV. CODE §§ 3094, 3129 (West 1974). *See infra* note 91 and accompanying text (discussing the nonresponsibility statute in more detail).

48. This statement is based on the types of construction matters the authors have handled in recent years.

49. *See supra* notes 17-24 and accompanying text (discussing the *Los Banos* decision).

50. 101 Cal. App. 3d 226, 161 Cal. Rptr. 551 (1980). *See infra* notes 134-44 and accompanying text (discussing the holding in *Baker*).

51. *Baker*, 101 Cal. App. 3d at 235, 161 Cal. Rptr. at 556.

II. THE SOURCE AND APPLICATION OF CALIFORNIA'S MECHANICS' LIEN LAWS

Unlike most states, in California a mechanic's[52] right to impose a lien on property, which has been improved by his labor or materials, is constitutional rather than statutory. Article XIV section 3, added June 8, 1976, to the California Constitution establishes the right of mechanics' lien claimants to impose such a lien.[53] This constitutional provision also authorizes the state legislature to provide for the enforcement of mechanics' liens.[54]

The language contained in section 3 Article XIV and its predecessor Article XX section 15 was not self-executing, thus the sections are inoperative except as supplemented by legislative

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52. *See* CAL. CIV. CODE § 3110 (West 1974) (stating that the term "mechanic" is used to denote all classes of persons allowed under statute to enforce a mechanics' lien, which includes, but is not limited to, contractors, subcontractors, laborers, and materialmen).

53. Article XIV section 3 of the California Constitution states:

> Mechanics, persons furnishing materials, artisans, and laborers of every class, shall have a lien upon the property upon which they have bestowed labor or furnished material for the value of such labor done and materials furnished; and the Legislature shall provide, by law, for the speedy and efficient enforcement of liens.

CAL. CONST. art. XIV, § 3. The mechanics lien provisions contained in article XIV section 3 were originally contained in article XX section 15 of the California State Constitution of 1879.

54. CAL. CONST. art. XIV, § 3. In *Connolly Dev., Inc. v. Superior Court*, 17 Cal. 3d 803, 132 Cal. Rptr. 477 (1976), the constitutionality of the mechanics' lien section was challenged on the basis that it was a taking of property without due process under the 14th Amendment to the United States Constitution. *Connolly*, 17 Cal. 3d at 816-28, 132 Cal. Rptr. at 486-94. In finding the mechanics' lien provision constitutional the California Supreme Court stated:

> [W]e conclude that the recordation of a mechanics' lien . . . inflicts upon the owner only a minimal deprivation of property; that the labor and materialman have an interest in the specific property subject to the lien since their work and material have enhanced the value of that property; and that state policy strongly supports the preservation of laws which give the laborer and materialman security for their claims. [W]e conclude that the safeguards provided by California law to protect property owners against unjustified liens are sufficient to comply with due process requirements. We therefore uphold the constitutionality of the mechanics' lien . . . laws.

Id. at 827-28, 132 Cal. Rptr. at 493-94. In 1969, the legislature repealed the previous mechanics' lien provisions contained in the Code of Civil Procedure and enacted substantially the same provisions in Title XV of the Civil Code. 1969 Cal. Stats. ch. 1362, § 2, at 2752. Except where this new legislation specifically changed prior law, it is assumed that prior court decisions retain precedential value for their application or interpretation of provisions of the prior law.

action.[55] The legislature, in carrying out this constitutional mandate, enacted Chapters 1 and 2 of Title XV, Part 4, Division III of the Civil Code,[56] entitled "Works of Improvement."[57] Under this statutory scheme, laborers,[58] contractors,[59] subcontractors,[60] materialman,[61] or other persons[62] who furnish labor or materials to a work of improvement are entitled to file a mechanics' lien on the property where the improvement is located.[63]

As a precondition to imposing a mechanics' lien, the mechanic must prove the existence of either an express or implied contract between himself and the owner of the property, or the owner's personal representative.[64] Civil Code section 3110 limits the mechanics ability to impose a lien on property to situations in

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55. *See* Frank Curran Lumber Co. v. Eleven Co., 271 Cal. App. 2d 175, 183, 76 Cal. Rptr. 753, 757 (1969) (holding that mechanics' liens can be foreclosed upon in a manner similar to a mortgage deed of trust in order to satisfy the amount due under the mechanics' lien).

56. CAL. CIV. CODE §§ 3082-3268 (West Supp. 1992).

57. CAL. CIV. CODE § 3106 (West 1974). "Work of improvement" includes but is not restricted to the construction, alteration, addition to, or repair, in whole or in part, of any building. *Id.*

58. *See id.* § 3089 (defining a "laborer" means any person who, acting as an employee, performs labor upon or bestows skills or other necessary services on any work of improvement).

59. *See id.* § 3095 (defining "Original contractor" as any contractor with a direct contractual relationship with the owner). Cases interpreting the predecessor statute of section 3095 (§ 1187 and § 1194 - repealed in 1951) have made clear that in order for the mechanic to be classified as a "contractor" a contractual relationship with the owner or lessee must be shown and the contractor must furnish both labor and materials. *See e.g.*, Sparks v. Butte County Gravel Min. Co., 55 Cal. 389 (1880); Baird v. Peall, 92 Cal. 235, 28 P. 285 (1891).

60. *See* CAL. CIV. CODE § 3104 (West 1974) (defining a "subcontractor" as any contractor who has no direct contractual relationship with the owner. A subcontractor furnishes both labor and materials in performing a segment of the total project. *Id.*

61. *See id.* § 3090 (defining a "materialman" as any contractor who furnishes materials or supplies to be used or consumed in any work of improvement). The materials supplied can be for either the owner, the contractor, or the subcontractor. *Id. See* 8 MILLER & STARR, CURRENT LAW OF CALIFORNIA REAL ESTATE § 26:7-10 (1990) (explaining the terms contractor, subcontractor, materialman and laborer).

62. *See* CAL. CIV. CODE § 3110 (West 1974) (providing that persons other than contractors, subcontractors, laborers, and materialman can enforce mechanics' liens against the owner's property). An example of the persons falling within the protection of this statute are architects, engineers, and material shipping personnel. *Id.*

63. *Id.* §§ 3082-3268 (West Supp. 1992).

64. This statement is based on the authors' interpretation of California Civil Code section 3110 as discussed below.

which labor or materials are supplied at the "owner's insistence."[65] This language directly implies that a contract between the mechanic and the property owner is required.[66] The notion of the existence of a "contract precondition" to the enforcement of a mechanics' lien is strengthened by Civil Code section 3123.[67] This section provides in part that mechanics' liens shall be valued at the price agreed upon by the claimant and the person with whom he "contracted."[68] When read together, sections 3110 and 3123 clearly make the existence of a contract a necessary precondition to the imposition of a mechanics' lien on the benefitted property.[69]

Section 3110 removes some additional road blocks to the enforcement of a mechanics' lien against the owner's property by designating a wide variety of persons to be the personal representative or agent of the owner for the purpose of proving the existence of an express or implied contract.[70] The section provides that "every contractor, subcontractor, architect, builder, or other person having charge of a work of improvement or portion thereof shall be held to be an agent of the owner."[71]

Assuming a contract for the mechanics' services can be shown, to secure a lien, a mechanic, other than the general contractor, must file a preliminary notice with the owner, the general contractor and the lender within twenty days after furnishing the labor or materials

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65. CAL. CIV. CODE § 3110 (West 1974). The section provides, in pertinent part: "[The mechanic] shall have a lien on the property upon which they have bestowed labor or furnished material . . . whether done or furnished at the insistence of the owner . . . ." *Id.*

66. This statement is based on the authors' interpretation of California Civil Code section 3110 as discussed below.

67. CAL. CIV. CODE § 3123(a) (West 1974). This section provides, in pertinent part: "The liens provided for in this chapter shall be direct liens, and shall be for the reasonable *value* of the labor, services, equipment, *or* materials furnished or for the *price* agreed upon by the claimant and the person with whom he contracted, whichever is less . . . ." *Id.*

68. *Id.*

69. The terms "owner's insistence" and "contracted" contained in these two statutes support the proposition that there must be a contract to which the owner is a party prior to the enforcement of a mechanics' lien on a particular work of improvement.

70. CAL. CIV. CODE § 3110 (West 1974).

71. *Id.* This would include a lessor of space in accordance with the holding in Baker v. Hubbard, 101 Cal. App. 3d 226, 161 Cal. Rptr. 551 (1980). *See infra* notes 134-144 and accompanying text (discussing the holding and rationale of *Baker*).

to the work of improvement.[72] Thereafter, the mechanic must record his claim of lien within ninety days of the completion of the improvement.[73] Once recorded, the mechanics' lien constitutes a direct lien[74] and a competing property interest to the legal holder of title to the property.[75] The lien is subordinate to all encumbrances recorded prior to the commencement of the work of improvement, but it has priority over all subsequent recorded encumbrances.[76] Thus, within this system of claim priorities, a claimant can foreclose his lien on the real property, force a sale of the real property, and receive payment from the proceeds of the sale.[77]

Assuming the lien was properly recorded, and based on an existing contract between the mechanic and the property owner, the proper value of the lien must be determined. Guidance on determining the appropriate lien amount is provided in Civil Code section 3123, which limits the lien amount to either the reasonable value of labor or materials provided or the contract price of the labor or materials, whichever is less.[78] Thus, under section 3123, the materials furnished but not used in the construction or improvement of the owner's property cannot be included in the lien value.[79] Also, the materialman or lien claimant has the burden of

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72. This action must comply with statutorily enumerated requirements. CAL. CIV. CODE §§ 3097, 3097.1, 3114 (West Supp. 1991). An exemption to the twenty-day notice requirement is provided by statute if the mechanic can demonstrate he is under a direct contract with the owner. *Id.* § 3097(a) (West Supp. 1992).

73. *Id.* § 3116 (West 1974). *See infra* notes 78-79 and accompanying text (discussing the elements a mechanics' lien must contain).

74. *See* CAL. CIV. CODE § 3123 (West 1974) (discussing direct liens).

75. *Id.* § 3128 (West 1974).

76. *Id.* § 3134 (West 1974).

77. The foreclosure of a mechanics' lien is an equity proceeding which resembles the foreclosure of a mortgage secured by a deed of trust. *See* Withington v. Shay, 47 Cal. App. 2d 68, 73, 117 P.2d 415, 417 (1941) (holding that mechanics' liens can be foreclosed in a manner similar to that of a mortgage deed).

78. CAL. CIV. CODE § 3123 (West 1974). *See supra* note 65 (quoting the relevant language of section 3123).

79. *See* California Portland Cement Co. v. Wentworth Hotel Co., 16 Cal. App. 692, 700-02, 118 P. 103, 106-07 (1911) (holding that, where mechanics' liens were placed on real property for materials furnished but not used in construction, such liens cannot be sustained beyond the amount of material actually used absent an abandonment of the project by the contractor).

proving that the materials furnished or the services provided were used in the building or renovation on the owner's property.[80]

Once the lien claimant has imposed and established the amount of the lien, the value of the owner's property subject to the mechanics' lien must be determined. Civil Code section 3112 provides statutory guidance on this point.[81] Under this provision, the entire interest of the owner becomes security for the payment of the lien or, in other words, the lien is imposed on the entire property benefitted.[82] The extent to which benefitted property can become the subject of a mechanics' lien was discussed in *Scott, Blake, & Wynne v. Summit Ridge Estates, Inc.*.[83]

In *Scott*, the plaintiff was a licensed land surveyor and civil engineer.[84] The plaintiff entered into a contract with Summit Ridge Estates to render surveying services on a tract of land.[85] Due to new acquisitions by defendants and redesigns by plaintiff, the boundaries of the tract were subsequently increased.[86] Upon defendants' failure to pay the contract price for the surveying services, plaintiff recorded a mechanics' lien on the tract, including land added to the tract after the signing of the contract.[87] On the issue of what property can be the subject of a mechanic's lien, the court of appeal, affirming the trial court, held that plaintiff was entitled to a lien on the whole tract, including land added to the tract after the signing of the contract.[88] The court reasoned that

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80. To determine what proof must be provided, see Consolidated Elec. Distrib., Inc. v. Kirkman, Chaon & Kirkman, Inc., 18 Cal. App. 3d 54, 58, 95 Cal. Rptr. 673, 675-76 (1971) (holding that, to recover on its claim, a lien claimant must prove the materials furnished were actually used in the improvements and that proof of delivery alone was not sufficient evidence).

81. California Civil Code section 3112 provides, in pertinent part:

> Any claimant who, at the insistence or request of the owner (or any other person acting by his authority or under him, as contractor or otherwise) of any lot or tract of land, has made any site improvement has a lien upon such lot or tract of land for work done or materials furnished.

CAL. CIV. CODE § 3112 (West 1974).

82. *Id.*

83. 251 Cal. App. 2d 347, 59 Cal. Rptr. 587 (1967).

84. *Id.* at 351, 59 Cal. Rptr. at 589.

85. *Id.*

86. *Id.* at 351-52, 59 Cal. Rptr. at 590.

87. *Id.* at 352-53, 59 Cal. Rptr. at 590.

88. *Id.* at 356, 59 Cal. Rptr. at 592-93.

services performed on real property outside the physical boundaries of the original tract benefitted the tract itself, and thus, all properties subsequently incorporated within the tract were subject to the mechanics' lien.[89] Since the statutes relating to the enforcement of mechanics' liens are remedial in nature, they are to be liberally construed to achieve their effected purpose of avoiding the unjust enrichment of property owners.[90]

The code sections discussed above provide a step by step analysis of the mechanics' remedies. Against these remedies, the statutory scheme balances the interests of property owners. To prevent mechanics' liens from being unjustly imposed on the owners of property, Civil Code sections 3129 and 3094 regulate the posting and recording of a notice of nonresponsibility.[91] Section 3094 provides that if the property owner records the nonresponsibility notice within ten days after receiving knowledge of the work of improvement, and posts the notice in a conspicuous place on the site, the property owner will not be liable for the work

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89. *Id.*

90. *See* Nolte v. Smith, 189 Cal. App. 2d 140, 144-46, 11 Cal. Rptr. 261, 263-64 (1961) (holding that the purpose of mechanics' lien laws is remedial in character and therefore should be liberally construed to effect its objectives and promote justice).

91. CAL. CIV. CODE §§ 3129, 3094 (West 1974). California Civil Code section 3129 provides, in pertinent part:

> Every work of improvement constructed upon any land and all work or labor performed or materials furnished in connection therewith with the knowledge of the owner . . . shall be held to have been constructed . . . at the instance of the owner . . . [and as] such. . . shall be subject to any lien recorded under this chapter unless such owner . . . shall give notice of nonresponsibility pursuant to Section 3094.

Id. § 3129 (1974). California Civil Code section 3094 provides, in pertinent part:

> Notice of nonresponsibility" means a written notice, signed . . . by [the] person owning or claiming an interest in the site who has not caused the work of improvement to be performed, or his agent, containing the following:
>
> (a) A description of the site sufficient . . . for identification.
>
> (b) The name and nature of the title or interest of the person giving the notice.
>
> . . .
>
> (d) A statement that the person giving . . . notice will not be responsible for any claims arising [out of] the work of improvement.
>
> Within 10 days after the person claiming the benefits of nonresponsibility has obtained knowledge of the work of improvement, the notice . . . shall be posted in some conspicuous place on the site. Within the same 10 day period . . . the notice shall be recorded . . . .

Id. § 3094 (West 1974).

of improvement.[92] Courts have strictly interpreted the ten-day filing and posting requirement for an owner who initially authorized the work of improvement on its property.[93]

As discussed above, the notice of nonresponsibility shield is not bulletproof. If the property owner "participates" through lease provisions by requiring the lessee to make improvements to the leasehold, the owner cannot shield its property interest.[94] In *Los Banos Gravel Co. v. Freeman*,[95] the court stated that an owner who has authorized the construction of improvements, either directly or though an agent, cannot escape liability for mechanics' liens recorded by a contractor hired by the lessee by later posting and recording a notice of nonresponsibility.[96] Under these circumstances, the law declares that the claimant, who contracted with the lessee, has a direct contract with the owner.[97] Further, the law deems the property owner to have authorized the lessee's construction as of the moment it was authorized by the lessee, and thus, the property owner cannot later evade mechanics' lien responsibility by timely posting and recording a notice of nonresponsibility.[98]

The purpose of both the constitutional mechanics' lien provision and its accompanying statutory provisions is three-fold. First and foremost, they provide for a method by which mechanics can secure payment for labor performed or services provided.[99] Second, they help prevent the unjust enrichment of the property

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92. CAL. CIV. CODE §§ 3094 (West 1974).

93. *See, e.g.*, Los Banos Gravel Co. v. Freeman, 58 Cal. App. 3d 785, 800, 130 Cal. Rptr. 180, 188-89 (1976); *see supra* notes 17-24 and accompanying text (discussing the *Los Banos* decision).

94. *Los Banos*, 58 Cal. App. 3d at 794-95, 130 Cal. Rptr. 180, 185-86.

95. 58 Cal. App. 3d 785, 130 Cal. Rptr. 180 (1976).

96. *Id.* at 793, 130 Cal. Rptr. at 184.

97. *Id.* at 795, 130 Cal. Rptr. at 185.

98. *Id.* at 793, 130 Cal. Rptr. at 184.

99. *See* Nolte v. Smith, 189 Cal. App. 2d 140, 143-44, 11 Cal. Rptr. 261, 263 (1961) (holding that public policy supports the securing of payment by mechanics for labor performed or material rendered).

owner.[100] Finally, the mechanics' lien statutory scheme provides a balance between the rights of a lien claimant and those of the property owner. The court in *Alta Building Material Co. v. Cameron*[101] best described the legislature's balancing act of the mechanics' and the owner's competing interests.[102]

While balancing the rights of property owners and mechanics has been given lip service by the court, the balance seems to have tipped toward permitting recovery by a mechanics' lien claimant.[103] The skewed drafting and interpretation of the mechanics' lien provisions in favor of the mechanics' lien claimant[104] has been further distorted by the liberal interpretation of the participating owner doctrine, which is discussed in the next section.

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100. 8 MILLER & STARR, CURRENT LAW OF CALIFORNIA REAL ESTATE § 26:2 (1990). Unjust enrichment arises when a mechanic has provided labor or materials for the erection or renovation of a building attached to the owner's real property and is subsequently not paid. The owner in such a case has likely incurred a windfall increase in the value of his property. Even where, due to the actions of the owner, the value of the owner's property is not increased by the provision of the mechanics' services, it still constitutes an unjust enrichment for the owner to fail to pay the mechanic. *See* McIntosh v. Funge, 210 Cal. 592, 599-602, 292 P. 960, 963-64 (1930) (exemplifying the extent to which a court will go to prevent the unjust enrichment of the property owner).

101. 202 Cal. App. 2d 299, 20 Cal. Rptr. 713 (1962) (holding pre-lien notice requirement constitutional).

102. *Id.* at 303-05, 20 Cal. Rptr. at 716. The court described its analysis:

> While the essential purpose of the mechanics' lien statutes is to protect those who have performed labor or furnished material toward the improvement of the property of another [citation], inherent in this concept is a recognition also of the rights of the owner of the benefitted property. It has been stated that the lien laws are for the protection of the property owners as well as lien claimants [citation] and that our laws relating to mechanics' liens result from the desire of the Legislature to adjust the respective rights of lien claimants with those of the owners of property improved by their labor and material.

Id.; accord Baker v. Hubbard, 101 Cal. App. 3d 226, 233-34, 161 Cal. Rptr. 551, 556 (1980); *see infra* note 144 and accompanying text (discussing the holding in *Baker*).

103. *See* CAL. CIV. CODE § 3109 (West 1974) (stating that the mechanics' lien remedy is available exclusively for works of improvement on private property). *See* Mayrhofer v. Board of Educ., 89 Cal. 110, 112-14, 26 P. 646, 646-47 (1891) (holding public property is exempt from mechanics' lien foreclosure actions).

104. *See* Hutnick v. United States Fidelity & Guarantee Co., 47 Cal. 3d 456, 462, 763 P.2d 1326, 1329, 253 Cal. Rptr. 236, 239 (1988) (holding that mechanics' lien statutes are to be liberally construed to protect mechanics' lien claimants).

III. HISTORY OF THE PARTICIPATING OWNER DOCTRINE

As stated in Section I, most states have adopted the general rule that the installation or provision of leasehold improvements by a lessee or tenant cannot subject the lessor's real property interest to a mechanics' lien even though the improvements are permanent.[105] Through legislative enactment, California has adopted this general rule.[106] However, California has also adopted the following two exceptions to the lessor nonliability rule: (1) The nonresponsibility statute,[107] and (2) the judicially created participating owner doctrine under which the lessee is held to be the implied agent of the lessor.[108]

The term participating owner was first used in the California case of *Hayward Lumber & Investment Co. v. Ford*.[109] In *Hayward*, the defendant, Vigario, was the owner of commercial property.[110] Vigario and the lessee, Ford, entered a lease under which Vigario gave Ford access to a portion of the property on which a building was located.[111] The lease provided that any alterations or additions made to the premises would remain the property of the lessor at the termination of the lease.[112] Subsequently, Vigario purchased some gravel to be used for both the leased portion of the property and the property remaining under the control of the lessor.[113] Ford then began to construct leasehold improvements, but he was subsequently forced to file

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105. *See supra* notes 10-15 and accompanying text (discussing a lessor's liability for mechanics' liens under the common law rule).

106. California Civil Code section 3128 provides, in pertinent part: "The liens provided for in this chapter shall attach to the work of improvement and the land on which it is situated . . . but if such person owned less than a fee simple estate in such land then only his interest [shall be] subject to [the] lien, except as provided in Section 3129." CAL. CIV. CODE § 3128 (West 1974).

107. *Id.* § 3094 (West 1974). *See supra* notes 91-93 and accompanying text (discussing the nonresponsibility statute).

108. *See supra* notes 105-53 and accompanying text (discussing the judicially created participating owner doctrine).

109. 64 Cal. App. 2d 346, 148 P.2d 689 (1944).

110. *Id.* at 347-48, 148 P.2d at 690.

111. *Id.* at 348, 148 P.2d at 690.

112. *Id.*

113. *Id.*

bankruptcy.[114] The plaintiff, a supplier of materials to the lessee, placed a mechanics' lien on the property, claiming that Vigario's provision of gravel to the property was sufficient involvement to classify Vigario as a participating owner.[115] The court of appeal rejected the plaintiff's characterization of Vigario's involvement in the leased property by holding that the provision of goods for use by both the lessor and the lessee did not make the lessor a participating owner.[116]

The seminal case in the development of the participating owner doctrine is *Ott Hardware Co. v. Yost.*[117] In *Ott*, defendants owned property on which a dilapidated theater stood.[118] A lease was executed under which the defendant's retained control over the renovation plans and specifications, and the lessees did not have the right to remove any installed improvements at the expiration or termination of the lease.[119] The lease was to remain in escrow until all the improvements were made and paid in full.[120] Subsequently, the lessees contracted with the plaintiffs to provide labor and materials for the renovation project.[121] After the lessees failed to pay the plaintiffs, mechanics' liens were recorded against the property.[122] The trial court upheld imposition of the mechanics' liens on the grounds that the owners would not have entered into the lease unless the lessees had promised to substantially improve the premises.[123] In affirming the trial court decision, the court of appeal indicated its approval of the general rule that an owner/lessor is liable for a mechanics' lien placed on the property as a result of the actions of the lessee where the lease

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114. *Id.* at 348-51, 148 P.2d at 690-92.

115. *Id.* at 351, 148 P.2d at 692.

116. *See Id.* (interpreting Western Etc. Co. v. Merchants Etc. Co., 13 Cal. App. 4, 108 P. 891 (1910)). The *Western* court held that the trial court had jurisdiction to render a judgment against the property owner in a consolidated action to foreclose mechanic's liens. *Western*, 13 Cal. App. at 8, 108 P. at 894.

117. 69 Cal. App. 2d 593, 159 P.2d 663 (1945).

118. *Id.* at 594, 159 P.2d at 664.

119. *Id.*

120. *Id.* at 595, 159 P.2d at 664.

121. *Id.* at 595, 159 P.2d at 664.

122. *Id.*

123. *Id.* at 596, 159 P.2d at 665.

requires the lessee to make leasehold improvements.[124] The court of appeal also stated that a participating owner, even though acting through his agent, the lessee, cannot shield its property from mechanics' liens by posting and recording a notice of nonresponsibility.[125] The owners were found to have played an active role in having the leasehold improvements installed, as well as conditioning the granting of the lease on the installation of substantial leasehold improvements.[126] As a result of this case, owners/lessors may be classified as participating owners, and thereby lose the protection otherwise afforded by the rule of nonliability as codified in Civil Code section 3128.[127]

The next case which discussed the participating owner doctrine was *Los Banos Gravel Co. v. Freeman.*[128] *In Los Banos*, the lease provided that: (1) The lessee must start construction within 120 days of executing the lease or it would become void; (2) the lessee could not make alterations to the property without the lessors' consent; and (3) the lessee was required to pay a portion of the gross profits to the lessor.[129] After the lessee failed to pay the contractors, mechanics' liens were filed against the property.[130] The trial court entered judgment in favor of the owner and the plaintiffs appealed.[131] The court of appeal reversed on the ground that the improvements were not optional under the lease, and thus, the owner was liable notwithstanding the recording of a notice of nonresponsibility.[132] The court provided a list of factors which supported its characterization of the owners/lessors as participating owners:

> [1] [the leased property] comprised but a small portion of a substantially larger acreage owned by the [lessor] . . . [2] the [lessor] [was] a

124. *Id.* at 597-98, 159 P.2d at 665-66.
125. *Id.* at 601, 159 P.2d at 667.
126. *Id.* at 601-602, 159 P.2d at 667-68.
127. CAL. CIV. CODE § 3128 (West 1974).
128. 58 Cal. App. 3d 785, 130 Cal. Rptr. 180 (1976).
129. *Id.* at 788, 130 Cal. Rptr. at 181.
130. *Id.* at 790, 130 Cal. Rptr. at 182.
131. *Id.* at 787, 130 Cal. Rptr. at 181.
132. *Id.* at 794-95, 130 Cal. Rptr. at 185-86.

> sophisticated and highly experienced commercial developer [who] [3] prepared a lease which compelled the lessee to construct a . . . facility, closely limiting the time within which the improvements must be accomplished . . . [4] lessor unqualifiedly restricted the use of the premises . . . to avoid competing and conflicting with other commercial uses contemplated by the [lessor] [5] the [lessor] wrote the lease to provide for a percentage rental agreement, the effect of which is to give him an on-going interest in the continuing operation of the premises . . . .[133]

Applying these factors to the terms of any commercial lease is integral to revealing whether the owner/lessor is simply leasing the property or is actively shaping the lessee's actions. If the lessor has taken an active role, then the lessor will be classified as a participating owner, and its property interest can be used to satisfy mechanics' liens.

The most recent California Court of Appeal decision to shape the participating owner doctrine is *Baker v. Hubbard.*[134] In *Baker*, Adams owned a 50 year-old building which was used as a convalescent center.[135] Adams entered into a five-year lease with Hartly, who agreed to continue to operate the center.[136] The lease required the lessee to pay for repair and maintenance of the building and obtain the lessor's consent before making alterations.[137] Three years into the lease, state officials informed the lessee that alterations would be necessary in order for the center to remain affiliated with the Medi-Cal program.[138] In response, the lessee attempted to obtain the lessor's consent to make the required alterations, but the lessor refused.[139] The lessee, without the lessor's consent, then contracted to have the work performed.[140] After the lessee failed to pay for the alterations, the contractor recorded a mechanics' lien against the

133. *Id.* at 797-98, 130 Cal. Rptr. at 187.
134. 101 Cal. App. 3d 226, 161 Cal. Rptr. 551 (1980).
135. *Id.* at 229, 161 Cal. Rptr. at 553.
136. *Id.*
137. *Id.* at 229-30, 161 Cal. Rptr. at 553-54.
138. *Id.* at 231, 161 Cal. Rptr. at 554.
139. *Id.*
140. *Id.*

property claiming, among other things, that the lessor was a participating owner.[141] The trial court refused to find that the lessor was a participating owner.[142] The court held that the alterations were neither contemplated nor discussed at the time which the lease was executed, and the lessor had specifically declined to approve the alterations.[143] The court of appeal affirmed, holding that there was no support in the record that the lessor had imposed a mandatory duty on the lessee to make alterations.[144] Thus, a mandatory duty on the lessee to repair and maintain the leased premises is different than an affirmative duty to provide leasehold improvements or alterations. Where a lessee is only required to repair and maintain the leased premises, this duty is insufficient to support a finding that the lessee was the agent of the lessor or to result in classification of the lessor as a participating owner.

From these four California cases, *Hayward*, *Ott*, *Los Banos*, and *Baker*, the following factors can be discerned as relevant in determining whether the lessor will be held to be a participating owner, and thus, liable for mechanics' liens placed on the leased property, as a result of actions by the lessee, notwithstanding the posting of a notice of nonresponsibility. First, would the lessor have entered into the agreement in the first place had the lessee not made assurances that substantial improvements would be made?[145] Second, did the contract between the lessor and lessee specifically *require* or *obligate* the lessee to make leasehold improvements?[146] These improvements must go beyond providing

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141. *Id.* at 234, 161 Cal. Rptr. at 556.

142. *Id.* at 235, 161 Cal. Rptr. at 557.

143. *Id.*

144. *Id.* at 235-36, 161 Cal. Rptr. at 557-58.

145. *See* Ott Hardware Co. v. Yost, 69 Cal. App. 2d 593, 596, 159 P.2d 663, 665 (1945) (holding that given the condition of the property when the lease was entered into, the lessors would not have entered into the lease unless the lessees promised to substantially modernize the building).

146. *See id.* at 597-98, 159 P.2d at 665-66 (holding that where a lessor requires the lessee to make improvements, the lessee is generally held to be the agent of the lessor); *accord* Los Banos Gravel Co. v. Freeman, 58 Cal. App. 3d 785, 794-95, 130 Cal. Rptr. 180, 18586 (1976).

money to complete improvements[147] or requiring the lessee to perform routine maintenance on the property.[148] Third, did the lessor retain substantial control over the activities of the lessee, such as: (1) Requiring the lessee to provide the lessor with a portion of the leasehold profits;[149] or (2) requiring the lessee to get the lessor's approval of plans and specifications for the improvements;[150] or (3) requiring the reversion all improvements to the lessor upon termination of the lease.[151] Finally, the courts will evaluate the level of sophistication of the parties to the lease.[152] If the lessor is well-versed in the leasing of property and the lessee is not, this factor will be used as an additional indication that the lessor is a participating owner.[153] As discussed in the next section, financial institutions, under the lender liability doctrine, also run the risk of being found liable for mechanics' liens in a fashion similar to the participating owner doctrine.

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147. *See* Hayward Lumber & Inv. Co. v. Ford, 64 Cal. App. 2d 346, 348-51, 148 P.2d 689, 692 (1944) (holding that the purchase of gravel for use by the lessees in completing his improvements does not give rise to a participating owner classification).

148. *See* Baker v. Hubbard, 101 Cal. App. 3d 226, 235-36, 161 Cal. Rptr. 551, 557-58 (1980) (holding that requiring the lessee to provide building maintenance does not give rise to a participating owner classification).

149. *See* Los Banos Gravel Co. v. Freeman, 58 Cal. App. 3d 785, 797-98, 130 Cal. Rptr. 180, 187 (1976) (holding that where the lessor requires the lessee to accept a percentage rental agreement, the lessor can be classified as a participating owner).

150. *See Ott Hardware Co.*, 69 Cal. App. 2d at 599-601, 159 P.2d at 666-67 (holding that where the lessee is compelled to follow the lessor's plans and specifications in remodeling the leased premises, the lessor can be classified as a participating owner).

151. *See id.* (holding that where the lessor requires the lessee to leave the improvements at the end of the lease and the improvements substantial enhance the value of the property, the lessor can be found to be a participating owner).

152. *See Los Banos Gravel Co.*, 58 Cal. App. 3d at 797-98, 130 Cal. Rptr. at 186-88 (holding the level of a party's sophistication is a factor considered in determining whether a party is a participating owner).

153. *See Los Banos Gravel Co.*, 58 Cal. App. 3d at 797-98, 130 Cal. Rptr. at 186-88 (holding that where one party is a sophisticated land developer and is highly experienced in commercial contracts, a participating owner classification is more likely).

IV. THE LENDER LIABILITY DOCTRINE

The commercial lessor should also be aware of the potential for lender liability, a problem closely related to the participating owner doctrine. Under this theory, liability may arise should the lessor provide financing to the lessee to construct leasehold improvements. The liability imposed on lenders stems from the California Supreme Court decision in *Conner v. Great Western Savings & Loan Ass'n.*[154] In an opinion by Chief Justice Traynor, the supreme court held that the defendant lender's involvement in the construction process, which exceeded that of an ordinary construction lender, imposed on the lender an independent duty of care toward the ultimate purchasers of the facilities.[155] In *Conner*, Great Western lent money to a construction company that it knew had less than an optimal level of capitalization.[156] Because of this knowledge, the court assumed that the construction company would be more likely than not to "cut corners" where possible.[157] In addition to providing the construction financing, Great Western also retained the title and right to possession of the property,[158] and its loan fees were based on a percentage of the amount of money loaned.[159] Thus, the contract embodied some of the characteristics of a lessor-lessee arrangement.

The court, in justifying its decision to extend liability to the lender, did not find a joint venture, but instead found a generic general duty of care based on the level of Great Western's knowledge of the project.[160] The court indicated that it would impose liability on the lender whenever the lender exercised control over the project that exceeded the level normally exercised by a

154. 69 Cal. 2d 850, 447 P.2d 609, 73 Cal. Rptr 369 (1968).
155. *Id.* at 868-69, 447 P.2d at 619, 73 Cal. Rptr. at 379-80.
156. *Id.* at 864, 447 P.2d at 616, 73 Cal. Rptr. at 376.
157. *Id.*
158. *Id.* at 858, 447 P.2d at 612, 73 Cal. Rptr. at 372.
159. *Id.* at 861, 447 P.2d at 614, 73 Cal. Rptr. at 374.
160. *Id.* at 863-63, 447 P.2d at 615, 616, 73 Cal. Rptr. at 375-76.

construction lender.[161] This test is surprisingly similar to the test applied in the participating owner doctrine cases.[162]

Given the similarities between the lender liability doctrine and the participating owner doctrine, application of the lender liability doctrine to an ordinary construction project would leave the lender with only two viable options. First, the lender could provide financial support to the builder based on his/her reputation alone, without gaining a great deal of knowledge about the project, and thereby be insulated from liability. Second, the lender could do extensive oversight on the project to insure the quality and timeliness of the project, which would minimize liability exposure. Neither of these options are an optimum solution to exposure minimization. These are basically the same options facing the lessor under the participating owner doctrine.

V. CONCLUSION AND OPTIONS FACING COMMERCIAL PROPERTY OWNERS

Under the four decisions of the California courts of appeal interpreting the "participating owner" exception, the lessor of commercial property has three basic methods under which it can avoid or limit liability. First, the lessor could refrain from requiring the lessee to provide or install leasehold improvements. Second, if the lessor insists on some participation in the lease, it must select a responsible lessee, and then provide careful administration and oversight to ensure that the selected lessee pays those parties who provide materials, labor, or services to construct leasehold

161. *Id.* at 864, 447 P.2d at 616, 73 Cal. Rptr. at 376.

162. *Id.* The *Conner* decision has received criticism. For example, subsequent to the *Conner* decision, a case involving similar facts was decided by the California Court of Appeal. In Bradler v. Craig, 274 Cal. App. 2d 466, 79 Cal. Rptr. 401, (1969) the court of appeal refused to strictly follow the California Supreme Court holding in *Conner* and thereby limited *Conner's* application. *Id.* at 475, 79 Cal. Rptr. at 407. The lender in *Bradler* had approved the plans and specifications for a construction project. *Id.* at 469, 79 Cal. Rptr. at 403. After standing for several years, the foundations of the structures began to crack and the plaintiffs sued the lender. *Id.* at 470, 79 Cal. Rptr. at 403. The *Bradler* court held that the lender had no liability for the defects because their involvement was minimal and restricted. *Id.* at 477, 79 Cal. Rptr. at 408. *See supra* notes 145-53 and accompanying text (discussing the participating ownership factors and analysis).

improvements. The third method involves the creation of a fund, either through a letter of credit, escrow account or otherwise, to be posted by the lessee, to pay for all improvements, with lessor control over a portion of the fund. The failure to either avoid any indicia of participation by the lessor (which is admittedly unlikely) or to exercise precautions can lead to financial disaster *if* either lessee subsequently breaches a contract with a mechanic or the lessee becomes insolvent. Through the application of the participating owner doctrine, the lessor is unable to shield its property interests from the liability for mechanics' liens attached as a result of the lessee's actions.

Therefore, if the lessor wishes to either limit or avoid liability associated with leasehold improvements, precautions should be taken in drafting the lease so it does not appear that the lessor has specifically *required* or *obligated* the lessee to make leasehold improvements, or retained a substantial amount of control over the activities of the lessee. Otherwise the lessor could be classified as a participating owner and held liable for any and all mechanics' liens imposed on the property due to the actions of the lessee.

In the context of modern commercial lease arrangements, lessors and commercial lenders must be advised and made aware that their shield from liability from liens arising from the improvements constructed on behalf of lessees may very well be illusory. Given the liberal judicial interpretation of the mechanics' liens laws, lessors must consciously elect to take a "hands-off" approach to their lessee's actions or engage in "hands-on" involvement in the operational oversight, financial, and other standard leasehold matters. Caveat emptor.